



NEPC, LLC

**To:** Delaware Cash Management Policy Board – Investment Subcommittee  
**From:** John Krimmel, CPA, CFA, Partner  
**Date:** May 6, 2020  
**Subject:** Follow Up to Lazard Guideline Compliance Discussion

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### **Background**

At the Special Investment Subcommittee Meeting held on April 15, 2020, NEPC discussed an issue related to the Lazard Reserve Portfolio and adherence to the Cash Management Policy Board’s Investment Guidelines. Recall that Lazard’s portfolio held two Equipment Trust Certificates issued by Continental (now United Air Lines) and American Airlines. These securities were downgraded to BBB+ by S&P in March 2020 and fell out of compliance with the Investment Guidelines. This Memorandum and Appendix supplement the discussion held at that Special Subcommittee Meeting.

### **Timeline**

Appended to this memo is a Timeline of Events related to the downgraded securities. There is one point of clarification from the discussion last month, along developments that occurred after the April 15<sup>th</sup> meeting.

#### *Point of Clarification*

We indicated at the meeting that the securities in question were downgraded on March 23<sup>rd</sup> and March 25<sup>th</sup>. Upon further investigation, the American Airline security was downgraded on March 20<sup>th</sup> and the Continental United Airlines security was downgraded on March 25<sup>th</sup>. As noted during the meeting, OST Staff and NEPC were notified of the downgraded securities on March 26, 2020, six days after the first downgrade.

#### *Recent Developments*

After the Subcommittee meeting, Treasurer Davis, OST Staff and NEPC held a follow up call with Lazard on Wednesday, April 15, 2020. The purpose of the call was to communicate the position of the Investment Subcommittee the securities needed to be liquidated by the close of business on Friday, April 17, 2020. Lazard indicated they would comply with the directive.

#### *Sale of securities*

On Thursday, April 18, 2020, Lazard reported that both positions were liquidated. The Continental (United Air Lines) position was sold at \$85.50 and the American Airlines position was sold at \$63.00. Both positions resulted in a loss. The proceeds from the sale of the positions was \$8,037,138, resulting in a realized loss of \$2,734,515.

### **Issues for Discussion**

Because of this situation, there are two issues or concerns that we have with Lazard.



The first issue or concern is related to Section 11.3 of the Guidelines, which requires that when a security ceases to be a permissible investment as the result of a downgrade (1) “the bank or investment manager shall remove the security from the State's portfolio immediately without any consideration as to the investment gains or losses occasioned thereby” and (2) “a bank or manager shall report immediately any such violation and the action(s) taken to correct such violation to OST.”

It is concerning that it took six (6) days to communicate that a security was downgraded, which resulted in an out of compliance portfolio. Related to that is the issue of why Lazard didn't sell the security immediately upon falling out of compliance as directed in the CMPB's Guidelines. Lazard has not addressed the reason for either of the two initial delays.

The second issue or concern is why Lazard did not anticipate that airlines and their related securities would suffer impairment because of the COVID-19 situation and the President's order to restrict travel on January 31, 2020 (effective February 2, 2020). There was a six-week period between the travel restrictions, the dramatic reduction in airline passengers, and downgrade in the two securities.

Both issues are troubling. The first issue points to potential contractual (Notifications) and compliance (Guidelines) shortfalls. The second points to a weak macroenvironment outlook (Investment Process) shortfall.

### **Next Steps**

Discussion of the two issues raised in the preceding paragraph is warranted. We believe there are two potential outcomes of the discussion. The first option would be for the Subcommittee to send a letter to Lazard outlining these concerns and conveying that the issues will be taken into consideration when their contract is up for renewal. Alternatively, the Subcommittee could forego any sort of written reprimand and elect to pursue termination or suspension of Lazard's performance consistent with the terms of their contract.

We believe that both courses of action should be discussed and considered on May 6<sup>th</sup>. We look forward to sharing our thoughts with the Investment Subcommittee then.



## **APPENDIX**

### **Timeline for Lazard Downgraded Securities**

**Thursday, March 26, 2020** – OST and NEPC were notified by Lazard that two airline Equipment Trust Certificates (ETC's) in the portfolio being managed by them were downgraded by S&P to BBB+, which fell outside the OST's guidelines for permissible securities (A- S&P), (A3 Moody's) and (A- Fitch). American Airlines (AA) was downgraded by S&P on 3/20/20 and Continental/United Air Lines (UAL) was downgraded on 3/25/20. Moody's continued to maintain an A2 rating for the AA security and an A3 rating on the UAL position.

The table below summarizes key information regarding these two securities.

Ticker	Par	Coupon	% of Portfolio	Maturity	S&P Rating
AA	\$5,351,733	3.65%	3.65%	6/15/28	BBB+
UAL	\$5,661,652	4.15%	4.15%	10/11/25	BBB+

Lazard indicated that they were aware of the immediate sale requirement by the guidelines and were prepared to sell the securities. Given unprecedented market conditions, there is currently no market in these securities. That is, there were no bids and no offers on the bonds. Lazard indicated that they did not believe that a market would materialize in the near term, and that they would not be able to liquidate these bonds in the next several days.

The purpose of their call was to let OST know of the downgrade, describe the market conditions, and recommend that they hold the bonds until markets returned to normal and they could be liquidated in a reasonable manner.

NEPC and OST requested that regular communications be established regarding market conditions, and the status of the sale of the securities. Daily emails and frequent phone calls were requested (and subsequently held).

**Friday, March 27, 2020** – John Krimmel contacted the Investment Subcommittee Chairman, Dave Marvin, to explain the situation and request guidance / permission for Lazard to hold the securities for a short period of time until the market for these securities returns and they can be sold. Mr. Marvin indicated that was prudent given the market conditions – and that we should request that the bonds be sold as soon as possible. He also requested an update if the bonds were not sold within the next week (i.e., Friday, April 3, 2020).

**March 30, 31 and April 1, 2020** – (Monday, Tuesday and Wednesday) OST Staff and NEPC received daily email updates on the market conditions. No bonds were sold during this period.

**Thursday April 2, 2020** – OST Staff and NEPC had an extended telephone conversation with Lazard. Lazard indicated that the US airlines were reviewing a government bailout package and, if the conditions in the package were acceptable and agreed to by the industry, that transactions in airline bonds and ETC's would likely commence again. Lazard also noted that it could be an extended review and negotiation period before the airlines and the government reach a consensus on terms of the bailout.



**April 3, 6, 7 & 8, 2020** (Friday, Monday, Tuesday & Wednesday) – OST Staff and NEPC received daily email updates on market conditions. No bonds were sold during this period.

**Monday, April 6, 2020** – John Krimmel contacted and provided the Investment Subcommittee Chairman an update on the AA and UAL ETC situation. Mr. Marvin reiterated his desire to exit the positions as soon as possible.

**Thursday, April 9, 2020** – OST Staff and NEPC had an extended telephone conversation with Lazard discussing the AA and UAL ETC issues. Lazard indicated that a small position of \$4 million of similar bonds (not these same positions) were transacted at a spread of 400 – 500 basis points above comparable maturity Treasuries. They noted that bailout talks have been moving along and acceptance of a deal may be done over the weekend. OST and NEPC reiterated the position that the bonds do not meet guidelines, Lazard needs to proactively put these securities out for sale and that incurred losses were not a consideration. Further it was noted that the Guideline relaxation period had been extended well beyond the initial estimate of time and that sales needed to be completed shortly. Lazard indicated if a deal was reached over the weekend, they would begin marketing the UAL (better of the two positions) on Monday, April 13, 2020.

**Friday, April 10, 2020** – Markets closed in observation of the Good Friday holiday.

**Monday, April 13, 2020** – OST Staff and NEPC had an extended telephone conversation with Lazard. Lazard indicated that no deal had been struck over the weekend, but a dealer had been contacted and was actively working the UAL bond at Treasury + 460 bps. No sales were completed during the day. OST Staff and NEPC reiterated the position of out of compliance and the need to bring the portfolio back into compliance with the Guidelines.

**Tuesday, April 14, 2020** – Delaware Treasurer Colleen Davis, OST Staff and NEPC had an extended conversation with Lazard. The UAL bond continued to be marketed throughout the day, with no sales occurring. Lazard noted that another small ETC position in UAL had been transacted in the market (\$2 mm), but that it was not the same bond or collateral. Once again, the Delaware Treasurer, OST Staff and NEPC reiterated that these positions were out of compliance with the Guidelines and that Lazard needed to bring the portfolio back into compliance.

**Wednesday, April 15, 2020** – Deputy Treasurer Liza Davis and John Krimmel held an extended telephone conversation with Dave Marvin (9:00 am) to bring him up-to-date on the AA and UAL positions in advance of the Investment Subcommittee Meeting occurring later that afternoon.

This matter was discussed at the Special Investment Subcommittee Meeting. After much discussion, OST Staff and NEPC were directed to communicate the Subcommittee's desire to sell the two positions by the close of business on Friday, April 16, 2020. Further, Lazard was to be informed that if the securities were not liquidated per the Subcommittee's direction, that the Subcommittee would consider removing Lazard as a manager from the OST Reserve Portfolio.

OST Staff and NEPC had an extended telephone conversation with Lazard and communicated the Subcommittee's directive to Lazard.



**Thursday, April 16, 2020** – Lazard notified OST Staff and NEPC that both securities were sold and proceeds from the liquidation would be received on Monday. The AA position was sold at a price of \$63.00 and the UAL position was liquidated at \$85.50.

**Monday, April 20, 2020** – the proceeds from the sale were received by the custodian, Northern Trust.